Why I Do Not Favor Exchange Traded Stock Funds
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Be forewarned; this commentary is intended to be provocative.

First, let me offer a kind word for exchange traded funds (ETFs). Conventional wisdom has long informed investors that picking the right sectors is more important than picking the right stocks. ETFs provide an easy way to invest selectively in sectors and even specialized subsectors. The problem with this approach lies in the translation from concept to execution. By necessity such a methodology requires investors to rotate into and out of sectors in response to changing economic and market conditions. Knowing which sectors to abandon and which to enter, and when to do so, lies beyond the capability of most individual investors. Standard & Poor's *The Outlook* newsletter provides such advice on a regular periodic basis, but the track record of S&P's success in this endeavor is not well documented. Also, many market-capitalization-weighted ETFs are dominated by the big-cap names in a particular sector. Their performance can be largely replicated by simply buying a few leaders in a sector and owning them directly. There are benefits to this latter approach for those investors who seek the rewards of rising dividends and a degree of shelter from mass hysteria, which will be discussed below.

My primary bias against ETFs is that they are intended to be trading vehicles. An investment strategy predicated on trading per se is seldom successful for individual investors. (Interestingly, this is documented among members of congress whose stock trading activity enters the public record. For whatever reason, more than a few members of congress are frenetic traders. Hindsight reveals that most would do better to simply follow a prudent buy-and-hold strategy.)

Now, this perspective must acknowledge that for many investments there is a time to buy and a time to sell. One warning sign regarding selling is when you find yourself surrounded by geniuses. In 1999, there were numerous tech stock geniuses. The Forum briefly included an especially vocal member who fell into this category. He did not suffer fools easily and his participation in the Forum was brief. He outspokenly rejected the concept of "reversion to the mean." I hope he continues to be pleased with his investment in Cisco which he loudly proclaimed that he would "never sell." Similarly, in 2007 there were many real estate geniuses busily flipping Sun Belt properties on a serial basis making six-figure profits in a matter of months while ignoring the admonition that "trees don't grow to the sky." Recognizing times to buy is easiest in hindsight. March of 2009 was one such occasion. None other than George Soros advised investors to sell their stocks in May 2009! But investor sentiment is tracked by a number of organizations, including AAII, and when it reaches historic lows is often a buy signal.

Using ETFs to invest in broad indexes, such as the S&P 500, is a wonderful way to passively capture the fruits of a bull market. But, if investors have learned anything over the past decade it is that there is no magic bullet in owning broad indexes. They are just another way to time markets, including fast-growing foreign markets that can be highly volatile.

Another factor to consider when contemplating ETFs is that they are akin to sausage. ETF indexes can lack discrimination in what they include. This was illustrated in a memorable exchange during a nightly food-fight on the Larry Kudlow program on CNBC several years ago when speculation about venturing into bank stocks was a hot topic. One guest suggested buying a particular bank stock ETF. Another guest who was a hedge fund manager strongly retorted that such an approach was “nonsense” because banks defy generalization. He asserted that each bank is “an individual situation.” That admonition applies to other sectors as well.

An additional negative aspect of ETFs is that they are what I term “cop-outs” for financial managers. They allow such entrepreneurs to avoid the hard work of researching and following individual stocks. One place where this is on public display is when a heavyweight money manager who probably earns a seven-figure or even eight-figure compensation appears on financial cable TV to dispense his or her wisdom and ends up recommending a short list of ETFs. Do you suppose he or she is richly rewarded by wealthy clients for this broad-brush type of generalized advice? Some even admit that they actually invest in individual stocks rather than ETFs within the sectors recommended, but they won’t share that valuable specific information with viewers.

Finally, mutual funds in general and ETFs in particular taught an important lesson during the recent bear market. For investors who are interested in dividend funds, both managed and exchange traded, it may be instructive to investigate their dividend payment records over the past five years. Most non-financial individual stocks either maintained their dividends or even increased them annually over this historically difficult period. And, many high-quality stocks have regained their losses experienced during the bear market and gone on to new highs. Not so for many dividend mutual funds. When investors flee mutual funds in panic both the value of such funds suffer and so do the dividends they pay. Long-term fund investors have no choice but to “go with the flow.” If the investing public is emotionally motivated to buy high and sell low, fund investors who may not share that sentiment are, in effect, doing so by simply being invested in a publicly traded fund.

*This commentary does **not** constitute a recommendation to either buy or sell the funds mentioned. These funds are followed by prominent research services that can be accessed through the Fairfax County Public Library website at www.fairfaxcounty.gov/library. Do your own due diligence before making financial decisions.*